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Even Amid the Current Turmoil, Stocks Still Beat Bonds

Investors saving for retirement have no reason to fear day-to-day volatility.

By BURTON G. MALKIEL

The stock market continues to reflect the very modest economic recovery now under way in the United States. From January 2011 through mid-August 2012, the S&P 500 has produced moderate single-digit total returns. But many individual investors are not participating. Some $200 billion has flowed out of equity mutual funds since January 2011. Even more has flowed into bond funds, leading bond king Bill Gross to proclaim "the cult of equity is dying." Yet I believe that investors who pull their money out of the stock market today to invest in bonds are making a huge mistake.

Granted, the litany of uncertainties worrying investors is a long one. Europe is in recession, and it is far from clear that the euro zone will hold together. China is slowing. The U.S. risks falling off a "fiscal cliff" and, of course, election-year and tax-policy uncertainty abound. But there are always economic uncertainties.

The more persistent uncertainty plaguing individual investors is the fear that our markets are not working properly. Quantitative high-frequency trading, driven by computer algorithms, has, in the view of critics, destroyed our stock markets. Doug Kass, the president of Seabreeze Partners, recently exclaimed, "Kill the 'quants' before they kill us."

And the recent fiasco concerning Knight Capital and its errant computer that kept feeding incorrect orders into the market with no "stop button" is the latest strand in a long string of market meltdowns from the "crash of 1987" to the "flash crash" of 2010. Such "Knightmares" have convinced many individual investors that our stock markets are broken and that they are at a huge disadvantage relative to the pros. Neither of these propositions is true.

The Knight mishap actually provides a wonderful example of how well our stock markets work. When Knight's flawed sell orders hit the market, legions of floor traders and other market participants were happy to buy. Market prices quickly returned to normal, and the result was a transfer of $400 million from Knight to the savvy investors who were willing to take the other side of the trades. Knight's common stock lost more than two-thirds of its value. That's just the way markets are supposed to work.

Reuters

What about Knight's role as a market maker in the broad-based Exchange-Traded Funds (ETFs) that I have long favored for individual investors? Bid-asked spreads (and therefore transactions costs) temporarily increased as Knight stepped away from the markets. But those spreads attracted other market makers and traders as profit-seekers pounced on the opportunities to offer slightly better prices. Again, this is exactly how free markets ought to behave. After a few days the spreads on the most widely traded ETFs returned to normal. The conclusion is not that markets failed. On the contrary, the

Traders work on the floor of the New York Stock Exchange on Thursday.

markets punished Knight far more severely than regulators ever could. That's exactly what the capitalist system is designed to do.

Should individual investors have reason to abandon the stock market because of the increased volatility rapid-fire trading can cause? Not at all. Investors saving for retirement have no reason to fear day-to-day or week-to-week volatility. The correct response is not to "do something" but rather to "just stand there." Evidence continues to accumulate that the long-term investor who simply buys and holds low-cost broad-based index funds and (indexed) ETFs does not achieve mediocre returns but well-above-average returns. During 2011, index-fund investors outperformed over 80% of actively managed equity funds. The same results have continued in the first half of 2012.

Moreover, equities today are more attractive relative to bonds than at any other time in history. Locking retirement funds into "safe" 1.5% yielding Treasury securities is likely to be a sure loser after inflation. We live in a world where the developed nations are saddled with large indebtedness relative to income (i.e., GDP) and large fiscal deficits. Moreover, our aging populations will put even greater strains on entitlement programs over time. Thus far, the major action taken in Washington with respect to entitlements has been to increase coverage, not decrease costs. The political path that seems easiest is to keep interest rates low and hope that inflation will eventually reduce our indebtedness as it has in the past.

In this low-return environment, saving for retirement is extremely difficult. The return assumptions for most pension plans tend to be overly optimistic. Certainly, fixed-income investments will never earn the projected returns required. The only hope—both for individuals and for institutions running retirement portfolios—is to increase, not decrease, the share of the portfolio devoted to equities.

Mr. Malkiel is the author of "A Random Walk Down Wall Street" (10th ed., paper, W.W. Norton, 2012).

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